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Market Update

December 2016

Share markets stronger

Global share markets made strong gains in the fourth quarter. Stocks began the period on the back foot due to uncertainty surrounding the outcome of the US presidential election, US rate hike speculation, rising bond yields and concerns the European Central Bank was considering scaling back its stimulus efforts. However, sentiment turned positive in the wake of Donald Trump's surprise election victory as investors bet Trump's promises to cut taxes, ramp up infrastructure spending and ease regulation would help drive company profits higher. As a result, shares rallied through November and December with financials, energy and materials among the key beneficiaries. Stocks also benefited from some encouraging US and European earnings results, news OPEC's members had reached an agreement to curb production, further merger and acquisition activity globally and a series of improving US and Chinese economic data. Some profit taking, the US Federal Reserve (Fed)'s decision to raise rates in December and renewed geopolitical concerns did weigh on stocks toward the end of the quarter; the latter including heightened tensions in the South China Sea and the impeachment of South Korea's president, Park Geun-hye.

Emerging markets were also positive for the quarter, though they did underperform their developed peers.

Australian shares performed well over the period. Like their global peers, local stocks struggled early amid rising bond yields, US rate hike speculation and the uncertainty surrounding the outcome of the US presidential election before rallying strongly in the wake of Trump's win. Stocks also benefited from a 41% surge in iron ore prices, OPEC's historic production deal and fresh domestic merger and acquisition activity, including the multi-billion dollar battle between Tabcorp and The Pacific Consortium for control of Tatts Group.

RBA leaves interest rates on hold

The Reserve Bank of Australia (RBA) left the official cash rate unchanged at a record low 1.50% throughout the period; the central bank noting that the economy is continuing its transition following the mining investment boom. It would appear that the RBA is content to leave monetary policy alone in the near-term, acknowledging the weakness in third-quarter growth but maintaining the view that growth will pick up as exports increase. There were three important sentences added to the bank's latest post-meeting statement that point to a more hawkish tone and thus validate the view that interest rates will likely remain on hold in the absence of a deterioration in key domestic economic data. Specifically, the RBA said that "(globally) the outlook for inflation is more balanced than it has been for some time", that "conditions in the housing market have strengthened overall", and that "higher (commodity) prices are providing a boost to national income." The RBA concluded its December meeting by saying that "taking account of the available information, and having eased monetary policy earlier in the year, the Board judged that holding the stance of policy unchanged...would be consistent with sustainable growth in the economy and achieving the inflation target over time."

Domestic growth contracts

The local economy contracted in the third quarter of 2016 with gross domestic product for the three months ended 30 September coming in at -0.5%. The market had anticipated a drop of just 0.1%. Contributing to the outcome was a sharp decline in government spending and weaker business investment. It was the economy's biggest contraction in almost eight years. On an annual basis, the economy grew 1.8%; down from revised growth of 3.1% recorded in the 12 months ended 30 June.

Australian dollar flat

The Australian dollar (AUD) ended the final quarter of the year unchanged, as measured by the Australian Trade-Weighted Index . The local currency benefited in part from the strong jump in iron ore prices and expectations domestic interest rates have bottomed for this cycle. However, this was offset by a stronger US dollar (USD) and speculation Australia may be at risk of losing its coveted AAA credit rating. The AUD rose 9.5% against the Japanese yen, 1.0% against the euro and 0.1% against the British pound. It fell 5.2% against the USD.

Looking ahead

Russell Investments favoured scenario for global equities at the beginning of 2016 was for mid-to-low single-digit returns and a gradual rise in long-term interest rates; both of which largely played out over the year.

Looking ahead to 2017, it expects volatility to continue as investors grapple with the transition of power in the US, Fed rate hikes, European elections and the longer-term impact of Brexit.

Relative to the US, Russell Investments currently believes other developed markets represent better value, though it would like to see further signs of earnings growth and more confidence in the economic growth outlook. Emerging markets were thrown a curve ball by Donald Trump's recent election victory, as the possible rejection of international trade deals and the threat of higher global yields are both expected to have negative impacts. Although it believes the sector represents the best value of all the regional share markets on a longer time horizon, Russell Investments remain cautious about buying any dips.

Market Update

Russell Investments has a neutral outlook for both government and investment-grade bonds as the bond market has become oversold since Trump's win. In saying that, this is tempered by the fact that interest rates have remained depressed for quite some time. It feels bonds are still expensive and may face headwinds in the form of potential rising inflation and higher US interest rates. It also believes other expensive defensive assets such as listed property and infrastructure face similar issues due to their greater sensitivity to interest rate movements.

In terms of currencies, a combination of Trump's expected aggressive fiscal policy and the prospect of higher US interest rates may help drive up the USD.

Overall, Russell Investments expects global growth to remain positive in 2017 though at a slower pace, with downside risks of further market selloffs. The next three to six months in particular is likely to be a modest growth environment as markets adjust to higher levels of interest rates and potential changes to monetary and fiscal policy, especially in the US.

[1] The trade-weighted index for the AUD is an indicator of movements in the average value of the AUD against the currencies of our trading partners.